Monthly Letter

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Economic environment

According to recent business confidence surveys, the start of 2018 saw a further solid and broad-based expansion of global economic activity. For instance, the World Markit business confidence index is at its highest level since 2015. By region, business confidence is the highest in the Eurozone, reaching a 12-year high. Most forecasters have recently increased their 2018 and 2019 global economic growth projections, in part on the back of the expected impact of the recently approved US tax policy changes. The IMF is now expecting economic growth to reach 3.9% in 2018 and 2019 after 3.7% in 2017.

Indeed, the US tax policy changes are expected to stimulate activity, with the short-term impact in the US mostly driven by the investment response to the corporate income tax cuts and by increased household spending. As a by-product, stronger domestic demand in the US is projected to increase imports, thus stimulating world trade. It is also assumed that the decline in tax revenues will not be offset by short-term spending cuts, resulting in a deterioration in public finances. In fact, the resulting twin deficits – trade and public – seem to partly explain the depreciation of the dollar whose level is closer to a low since.

Several uncertainties surround these projections, first and foremost the magnitude of the response of US business investment to the tax policy changes. On the one hand, some companies may choose to increase their dividends, buy back their shares, or facilitate mergers and acquisitions rather than investing. Wealthy households – among the biggest winners in the tax plan – may well decide to save instead of consuming the tax windfall. In this light, the prospects for global economic growth look optimistic.

On the other hand, an economic acceleration even faster than envisaged could put upward pressure on inflation and lead to a more abrupt tightening of US monetary policy, contributing to the worsening of global financial conditions. The implications would be numerous, particularly regarding capital flows to countries with high financing requirements and dollar liabilities that would be vulnerable to financial difficulties. This is particularly the case for the non-financial corporations in emerging countries.

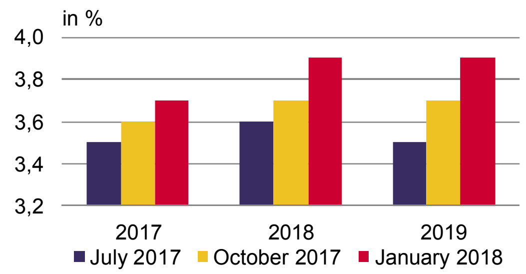
Until recently, the reaction of longer-term bond yields and the dollar to the expected higher US growth figures were limited. Yet, the latest data on US jobs and wage growth have triggered financial market volatility. Indeed, average hourly earnings grew 2.9% y/y in January, the highest rate since mid-2009, reviving the risks that firmer wage pressures could lead to higher inflation and thus higher interest rates.

Performances in local currency

	Price as of 01/31/18	1 month % change	2018 % change
Equity markets			
CAC 40	5 482	3.2%	3.2%
Eurostoxx 50	3 609	3.0%	3.0%
S&P 500	2 824	5.6%	5.6%
Nikkei 225	23 098	1.5%	1.5%
Currencies			
1 € = ...USD	1.25	3.7%	3.7%
1 € = ...JPY	135.60	0.4%	0.4%

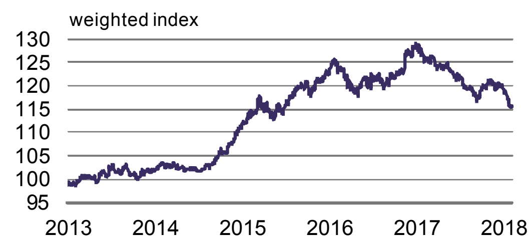
		Price as of 01/31/18	1 month bp	2018 bp
Government bonds				
3 M	Euro zone	-0.78%	20	12
3 M	United States	1.38%	86	88
10 Y	Euro zone	0.43%	-1	22
10 Y	United States	2.41%	-5	-4

World – IMF economic growth projections



Source IMF, Rothschild Asset Management

United States – Effective exchange rate



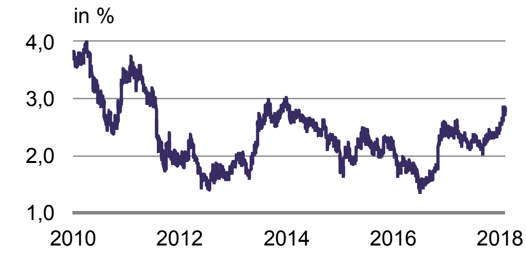
Source Bloomberg, Rothschild Asset Management

Although this scenario of too strong US growth, forcing the Fed to tighten more than otherwise would have been the case, is a real risk, one should remain cautious about extrapolating from the very recent trend of higher US wage growth. Indeed, the January rise was likely boosted by minimum wage gains, could have been influenced somewhat by the weather, and did not seem terribly broad-based. Indeed, just two sectors accounted for almost three-quarters of aggregate wage growth, and production and non-supervisory workers saw a more modest 2.4% y/y wage increase. What's more, the recent employment cost index (ECI) paints a more muted improvement in wage dynamics. The ECI is a more comprehensive measure of labor costs since it also includes benefits in the total pay package and is free from the influence of employment shifts among occupations and industries.

In sum, US wage growth might pick up in 2018, but the January hourly earnings figure may have overstated the acceleration. Meanwhile, higher economic growth and higher interest rates are not necessarily incompatible with higher risky assets as long as earnings momentum remains positive. Therefore, the current market volatility might have more to do with a healthy correction after months of uninterrupted gains in the equity market rather than the start of a real bear market.

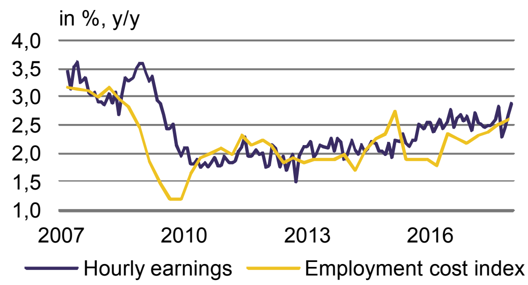
That said, some Fed members could see in the most recent statistics a justification for adding an additional rate hike to their projection, which would bring to four the number of hikes in 2018. The departure of Chair Janet Yellen, who was very sensitive to the full employment mandate of the Fed, adds some uncertainty, especially as new members are joining the Federal Open Market Committee. Some of them are well-known for their strong bias favouring the mandate of inflation and for their criticism regarding the accommodative policy stance adopted by the Fed since the crisis. The upshot is that the current turbulence is an early indication of how the investment backdrop will become much more challenging as global inflation continues to rise and central banks adjust accordingly.

United states – Government yields



Source Bloomberg, Rothschild Asset Management

United States– Private sector wage growth



Source Datastream, Rothschild Asset Management